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COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, DECEMBER 18, 2001

APPLICATION OF

A&N ELECTRIC COOPERATIVE

CASE NO. PUE010008

For approval of a functional
separation plan pursuant to
the Virginia Electric Utility
Restructuring Act

FINAL ORDER

On December 29, 2000, A&N Electric Cooperative ("A&N" or the "Cooperative"), filed an application for State Corporation Commission ("Commission") approval of the Cooperative's plan for functional separation ("Plan") as required by the Virginia Electric Utility Restructuring Act ("the Act"), Chapter 23 of Title 56 of the Code of Virginia (§ 56-576 et seq.) The Act requires that the Commission complete its review of proposed plans of separation by January 1, 2002, and that transition to competition be implemented according to a timeline established by the Commission. Pursuant to an Order issued on March 30, 2001, in Case No. PUE000740, the Commission established January 1, 2004, as the deadline for A&N and other electric cooperatives to provide full retail access for their customers.

The Commission promulgated rules¹ for functional separation as required by the Act. These Rules require the Cooperative to file a Plan that includes a cost of service study separating the Virginia jurisdictional operations into functions: generation, transmission, and distribution, subdivided by class and specifically identifying the costs associated with metering and billing. The Rules also require that the Plan include proposed unbundled rates, tariffs, and terms and conditions for service. Requests for waiver from the required submission of documents under the various sections of the Rules are also permitted.

In its application, the Cooperative stated that it is currently functionally separated. Except for A&N's diesel generators, it does not own or control any generation or transmission facilities, nor does it own or control any affiliated entity that owns or controls generation or transmission facilities.² Instead, A&N purchases all of its

¹ Commission's Regulations Governing the Functional Separation of Incumbent Electric Utilities under the Virginia Electric Utility Restructuring Act ("Rules"), 20 VAC 5-202-10 et seq., adopted in Case No. PUA000029.

² A&N stated in its application that it owns six diesel generators (4 of which are in service) that are positioned on Tangier Island and Smith Island in the Chesapeake Bay. The Cooperative stated that these generators are used on a stand-by basis, and help insure system reliability and provide system support on those islands, each of which is served by a single line from the mainland. A&N asserted that these generators operate primarily for distribution system reliability and support rather than to serve load, and it therefore regards them as distribution assets. The Cooperative stated it is not planning to functionally separate the nonfuel costs associated with these generators. Because Smith Island is in Maryland, only the generators on Tangier Island are at issue in this proceeding.

requirements for demand, energy, transmission and ancillary services through contracts with Old Dominion Electric Cooperative. As such, A&N stated that it had no plans to divest itself of any generation assets, to create any new functionally separate entity, or to propose to transfer any functions, services, or employees to a functionally separate entity or third party. The Cooperative filed a cost of service study, which included proposed unbundled rates to illustrate the Cooperative's rate unbundling. In its application, the Cooperative requested that the Commission waive the requirement of 20 VAC 5-202-40 B 8 of the Rules to file unbundled tariff rates and terms and conditions of service with the Cooperative's functional separation plan. The Cooperative also requested that the waiver extend until the conclusion of this proceeding so it can finalize and submit such filings in compliance with the final order.

In an Order dated March 14, 2001, in this proceeding, the Commission directed the Cooperative to provide notice to the public and established a procedural schedule for the filing of comments or requests for hearing on A&N's application. In that Order, the Commission directed its Staff to investigate the application and file a Report detailing its findings and recommendations on or before June 29, 2001. The Commission also granted A&N's request for a waiver. However, the Commission

required the Cooperative to file tariff terms and conditions of service in time for the Commission to consider them and to require notice, if necessary and appropriate, prior to the Cooperative's implementation of retail choice to its customers.

On June 4, 2001, AES NewEnergy, Inc. ("AES") filed a Notice of Protest and request for hearing in this matter.

Specifically, AES requested that a hearing schedule be established to consider issues relating to the allocation of certain costs to the generation and transmission ("G&T") functions, a dual billing option for suppliers, wires charge calculations, the terms and conditions of service included in any rate tariff or supplier coordination agreement, and allocation of the energy from A&N's diesel generators among competitive suppliers and the Cooperative. On August 1, 2001, AES withdrew its request for hearing.

On June 29, 2001, Staff filed its Report wherein it recommended that the Commission approve A&N's Plan with the adoption of certain modifications recommended by Staff. Specifically, Staff recommended that the Commission adopt the following: Staff's recommendation to consolidate the Cooperative's G&T functions into one function;³ Staff's adjustments to the Cooperative's per books cost of service

³ Staff noted that the Cooperative does not anticipate providing transmission service to customers who shop for energy.

study; Staff's allocations of expense and rate base to the G&T function; Staff's recommendation that the Commission direct the Cooperative to track the costs associated with G&T operations; and Staff's recommendation that the Commission direct A&N to provide tariff rates and terms and conditions of service in time for full consideration by the Commission.

On July 16, 2001, A&N filed its Response to the Staff Report. In its Response, the Cooperative stated that although it supports Staff's recommendation that the G&T functions be combined, it does not agree with Staff's recommendations pertaining to functional cost assignment. A&N objects to the Staff's assignment to G&T of all non-fuel costs associated with the Cooperative's diesel generators on Tangier Island, and the allocation of such costs to Schedules LP-B and LP-C. A&N noted that Tangier Island is isolated from the mainland and is supplied electricity by a single three-phase circuit consisting of submarine cables, which are sometimes out of service. A&N argued that the primary role and purpose of the diesel generators is to provide back-up service when the cables are out, and that it is likely the Cooperative would not have the diesel generators absent the reliability requirements of Tangier Island. The Cooperative acknowledges that the generators are used to shave peak load, but maintains that only their fuel-related costs should be functionalized to G&T because the

primary purpose the generators serve is to support A&N's distribution system.

A&N requests that the Commission find that its administrative and general ("A&G") expenses and associated overheads are properly assignable to the distribution function because the rate paid by A&N to Old Dominion Electric Cooperative for power supply and transmission services includes a component for A&G expenses. A&N argued that assigning its A&G and overheads to G&T would, in effect, add a second layer of such costs to the generation component. Further, A&N argued that in its role as the local distribution service provider, it is required by the Act to provide default generation service under its capped rates. According to A&N, supplying default generation services provides a benefit available for all consumers on A&N's distribution system, including those consumers who may choose an alternative power supplier. A&N further stated that the responsibility bestowed on it to provide default service is a function of its role as the distribution utility. Thus, the Cooperative urged the Commission to reject Staff's proposal to assign A&G costs to the G&T functions. Additionally, the Cooperative contends that should the Commission decide that certain A&G costs be allocated to G&T, that such allocations be based on a total labor factor.

With regard to the Staff's recommendations concerning uncollectible expense, customer deposits, and interest on customer deposits, A&N agreed that a portion of these expenses should be attributed to G&T, but took issue with the Staff's method of allocation. A&N also disagreed with the Staff's assignment of costs relating to conservation advertising, and load management to the G&T function.

On August 24, 2001, the Staff filed a motion for leave to file a Reply to A&N's Response to the Staff Report, and its Reply. The Commission granted this motion on September 26, 2001, and permitted the Cooperative to respond to the Staff's Reply by October 12, 2001. In its Reply, the Staff disagreed with A&N's position that non-fuel costs associated with the diesel generators be functionalized as Distribution costs. The Staff did not dispute that the generators are used primarily for back-up service and secondarily for peak-shaving. The Staff stated that A&N's objections appear to be with the Act which requires the separation of generation assets and prohibits cost-shifting or cross-subsidies between functionally separate units. Staff noted that whenever customers on Tangier Island are served by the diesel generators, whether as the result of the submarine cables being out of service or as part of peak shaving, the customers are receiving generation service and not distribution service. The Staff agreed with A&N, however, that

costs associated the generators should not be allocated to schedules LP-B or LP-C.

In response to A&N's assertion that certain A&G costs should be allocated to Distribution, the Staff maintained its position that if these costs are shifted to Distribution, rates established for Distribution will subsidize those of G&T, contrary to § 56-590 D of the Code of Virginia, which requires the Commission to set rates that will not result in cost shifting or cross-subsidies between functional units. Regarding the Cooperative's argument addressing the proper allocation factor, Staff clarified that it allocated A&G overheads to G&T based on a modified total labor factor.

The Staff also reiterated its proposal to functionalize a portion of uncollectible expense, customer deposits and interest on customer deposits, conservation advertising costs, and all costs associated with A&N's load management programs to G&T. In addition, the Staff disagreed with A&N on (i) the proper ratio to use to allocate a portion of uncollectible expense, customer deposits, and interest on customer deposits to G&T, and (ii) the class or classes to which load management costs should be allocated.

A&N filed its response to the Staff's reply on October 12, 2001. In its response, the Cooperative continued to assert that non-fuel diesel generator costs should not be functionalized as

G&T costs. A&N contended the key issue in functionalizing these costs is the primary use of the equipment, and that the generators in question serve primarily a reliability support function for distribution service.

A&N maintained in its response that failure to attribute additional A&G expenses to the generation function does not result in cost-shifting or cross-subsidization of functionally separate units. In addition, A&N urged the Commission to consider its unique statutory obligation to provide default services in Virginia. The Cooperative continued to agree with Staff that a portion of uncollectible expense, customer deposits, and interest on customer deposits be assigned to the G&T function, but stated that the ratio used should be based on G&T revenues as a percentage of total revenues. With regard to conservation advertising and load management costs, the Cooperative maintained its position that all conservation advertising and 50% of load management costs should be considered part of the distribution function. The Cooperative did not further address the issue regarding the proper allocation factor for A&G overheads.

NOW THE COMMISSION, having considered the Cooperative's application, Staff's Report, the subsequent pleadings, and applicable law, is of the opinion and finds that the application

should be approved, subject to the modifications detailed herein.

We find that all of A&N's costs associated with its diesel generators must be allocated to the G&T function. The Cooperative's assertion that A&N's diesel generators might not exist absent the reliability requirements of Tangier Island does not change the fact that these units are in fact generation assets. All generation serves a distribution support function. As agreed by the Cooperative and the Staff, costs associated with the diesel generators should not be allocated to schedules LP-B and LP-C.

With respect to the issue of the proper allocation of A&G costs supporting the procurement of wholesale power, we find that the Commission has an obligation pursuant to § 56-590 D of the Code of Virginia to see that no cross-subsidies occur. The function causing the cost should be allocated such costs. A&G costs associated with the procurement of wholesale power support the G&T function, and as such, should not be allocated to the Distribution function. We will, therefore, accept Staff's adjustment allocating certain A&G costs associated with obtaining wholesale power to the Cooperative's G&T function. Further, we accept Staff's methodology for functional allocation of A&G overheads.

There are two ways that a cooperative may recover A&G costs associated with the procurement of wholesale power. If a customer remains with the cooperative, the cooperative will recover such costs from the customer. If the customer leaves the cooperative, and the embedded cost of generation exceeds the market, the cooperative will have the opportunity to recover the cost through the wires charge.

We likewise agree with Staff that the allocation factor for uncollectible expense, customer deposits, and interest on customer deposits should be based on each function's relative level of operating expense. We believe this is a reasonable approach in this situation as total G&T expense must be calculated in order to determine the level of G&T revenues, and operating expenses can be used to simulate unbundled revenue.

With regard to the costs for conservation advertising and load management, we find that these costs should be fully allocated to G&T, and that load management and related costs should be allocated across all customer classes, not just the residential class. Both the conservation advertising and load management costs are clearly related to generation, not distribution. The goal of conservation advertising is to reduce energy usage, thereby having a direct impact on generation and purchased power costs. Load management switches installed for peak shaving are a G&T component because they allow the

Cooperative to decrease its power costs by negotiating better rates from the supplier, and the Cooperative would not have load management switches simply for distribution purposes. Further, we agree with Staff that since all customers share in the benefits of lower wholesale power bills, all customers should share the costs, not just the residential class.

We find that G&T costs, as defined in this Order, should be tracked prospectively by the Cooperative in order to ensure accurate functional allocations in any future proceedings before the Commission. We also direct the Cooperative to begin tracking the incremental costs associated with billing and collection costs, as well as the activities that give rise to the customer service and legal and regulatory costs.

Finally, in its cost of service study, A&N discusses the impact of its monthly fuel adjustment factor in relation to the determination of the market price for generation and the wires charge. It is the Cooperative's position that fuel adjustments can be applied monthly without violating §§ 56-582 and 56-583 of the Code of Virginia. We are not persuaded by the Cooperative's argument on this point. However, because it is not necessary that we resolve this issue prior to January 1, 2002, we will defer our consideration of it until next year. In the interim, we direct the Staff to (i) consult with A&N, the other electric cooperatives, and any other interested parties on this issue and

(ii) submit a written recommendation to the Commission on or before March 1, 2002, on whether we should implement an annual fuel factor adjustment for the cooperatives in lieu of the current fluctuating monthly fuel charge.

Accordingly, IT IS ORDERED THAT:

(1) A&N's Plan for functional separation pursuant to the Virginia Electric Utility Restructuring Act is hereby approved, subject to the modifications discussed herein.

(2) On or before March 1, 2002, the Staff shall submit a written recommendation to the Commission on whether we should transition to an annual fuel factor adjustment for the cooperatives from the current fluctuating monthly fuel charge, and if so, how such a transition should occur.

(3) A&N shall provide tariffs and terms and conditions of service to the Division of Energy Regulation that conform to this Order and all applicable Commission Rules and Regulations one hundred fifty (150) days prior to its implementation of retail choice.

(4) This case is hereby dismissed, and the papers shall be placed in the file for ended causes.